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INCOME TAX CONSIDERATIONS IN THE TRANSITION TO A PROFESSIONAL CORPORATION

HARVEY DUNN*

IT HAS BEEN over three years since the Internal Revenue Service has announced that organizations of doctors, lawyers and other professional groups incorporated under state statutes permitting such will be treated as corporations for federal income tax purposes.¹ Although the announcement removed the dark cloud which existed over the formation of professional corporations, the income tax considerations incident to the transition from non-corporate to the corporate form of doing business remained the same both before and after the announcement. While the Service has permitted a relatively calm climate to exist for professional corporations since the time of its announcement, the basic considerations in forming a professional corporation remain just as important as ever if not more so. The "more so" theory results from the fact that the concession by the Service related only to the matter of recognizing professional corporations as corporations within the definition of such under the Internal Revenue Code.² Numerous other provisions of the Internal Revenue Code which might be applied to the professional corporation so as to substantially reduce or even nullify the advantages of the corporate form without a direct challenge to the point conceded by the Service remain as sleeping dogs today although on various occasions governmental officials have indicated they would soon be awakened.

The decision to form a professional corporation is usually prompted by the numerous income tax advantages available to the professional as an employee of a corporation rather than as self-employed; the single most important being the qualified pension and/or profit-sharing plan.³ Other advantages, perhaps of less import, although in many cases of significant dollar value, are such items as medical reimbursement plans,⁴ sick pay or wage continuation plans,⁵ group insurance programs⁶ and estate tax niceties such as the \$5,000 death benefit exclusion⁷ and exemption from

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¹ T.I.R. 1019 (August 8, 1969). See also Rev. Rul. 70-101, 1970-1 CUM. BULL. 278 and Rev. Rul. 70-455, 1970-2 CUM. BULL. 297.

² INT. REV. CODE OF 1954, § 7701(a)(3); Treas. Reg. § 306.7701-2 (1960), as amended, T.D. 6797, 1965-1 CUM. BULL. 553.

³ *Id.* at § 401.

⁴ *Id.* at § 105(b).

⁵ *Id.* at §§ 106, 105(d).

⁶ *Id.* at § 79(a).

⁷ *Id.* at § 101(b)(2)(A).

estate tax of pension plan and profit sharing plan benefits.⁸ This article is not intended to discuss those aspects of the professional corporation, but rather is directed at the tax and some of the business considerations incident to forming either a solo or group corporate practice.

The formation of a professional corporation may be as simple as the mere filing of articles of incorporation and the payment of money for shares of stock—a totally tax-free transaction.⁹ However, unless the circumstances are those of a professional whose very first day of practice is the day he forms his corporation, the matter will not be so simple. Where an existing professional practice is being incorporated the situation becomes complicated by such considerations as what to do with pre-existing accounts receivable, equipment, liabilities, leases and contractual commitments for services of a particular professional. The decision of how to handle these matters is affected by the circumstances, i.e., whether a solo or group practice is being formed and if the latter, the relationship between what each potential shareholder has to contribute.

Under general rules of taxation, the exchange of property for stock is treated as a taxable transaction and the gain (or loss) is measured by the difference between the fair market value of the stock received and the basis of the property relinquished in the exchange.¹⁰ The exchange of \$500 cash and equipment with a basis of \$1,000 and a fair market value of \$2,000 will result in a \$1,000 gain since the stock is worth \$2,500 and the basis of the property relinquished is \$1,500. This is the case whether there are one or more contributors of property to the corporation for stock. In the foregoing example, the \$1,000 gain is considered to be realized and recognized. A realized gain, or a realized loss, is the difference between the fair market value of what is received and the basis for tax purposes of what is given up in the exchange. A recognized gain or loss is one which has been realized and is required to be reported on a tax return.

In the matter of forming corporations, this leads to what is known as the "tax free" incorporation. As far back as the Revenue Act of 1921 there was recognition of a need to permit businesses to operate under the corporate form and to avoid an immediate tax on the paper transfer of assets. Through the years the tax-free incorporation provisions of the Internal Revenue Code remained and today exist as Section 351 of the Internal Revenue Code of 1954.¹¹ In relying on Section 351 two

⁸ *Id.* at § 2039(c).

⁹ *Id.* at §§ 351, 1032(a).

¹⁰ *Id.* at § 1001.

¹¹ *Id.* at § 351 which reads in part:

Section 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule. No gain or loss shall be recognized if property is transferred to a corporation... by one or more persons solely in exchange for stock or securities and immediately after the exchange such person or persons are in control [as defined in Section 368(c)] of the corporation...

factors must be remembered. First, a transfer of property to a corporation in exchange for stock is a transaction upon which gain (or loss) is realized, but not recognized. The corporation acquires the same basis in the property as that of the transferors¹² with the result that the recognition of the gain is not eliminated, but merely postponed. Second, as with any provision of the Internal Revenue Code exempting a realized gain on a transaction from immediate recognition for income tax purposes, the provisions of the law must be strictly complied with, otherwise, the benefit of the exemption is lost.

In essence, Section 351 provides that no gain or loss is recognized if one or more persons transfers property to a corporation in exchange for stock or securities of the corporation and immediately after the transfer such person or persons are in control of the corporation. While the definition of persons is very broad¹³ its application to professional corporations will be limited to professional individuals because of state statutes requiring shareholders to be persons licensed to practice the profession for which the corporation is formed.¹⁴ In cases where there is to be a group professional practice it is not necessary that all of the individuals make simultaneous transfers to qualify under Section 351.¹⁵ However, where existing partnerships are incorporated there would more than likely be simultaneous transfers and in most cases where two or more practices are combined, it would seem that all would want to begin their corporate organization together. Yet, it is evident from the Regulations that where one or more professionals form a corporation to begin operations immediately with the intention that additional professionals will also make transfers to the corporation in exchange for stock, the last transferor may be a part of the entire group to satisfy the requirements of Section 351, as long as the rights of the parties have been previously defined within the meaning of the Regulations.

If one is not considered to be a part of the transferor group, and upon his transfer of property to the corporation he alone does not acquire the requisite control, Section 351 will not have been complied with and any realized gain will be recognized immediately.¹⁶ Inasmuch as there are no definite guidelines as to how much time may lapse between transfers which are sought to be part of an integrated plan, conservative practice would dictate that such time be held to a very minimum. For example, a transfer of property by two professionals on January 1, with a subsequent transfer by a third professional six months later, even though all pursuant

¹² *Id.* at § 362(b).

¹³ Treas. Reg. § 1.351-1(a)(1) (1955), *as amended*, T.D. 6942, 1968-1 CUM. BULL. 136.

¹⁴ *E.g.*, OHIO REV. CODE § 1785.05.

¹⁵ Treas. Reg. § 1.351-1(a)(1) (1955), *as amended*, T.D. 6942, 1968-1 CUM. BULL. 136.

¹⁶ INT. REV. CODE OF 1954, §§ 61, 1002.

to the same agreement, might not qualify as a tax-free transaction as to the last individual to join the group. The lack of established guidelines in this area should be considered a mandate to exercise caution not only from a tax standpoint but also from a business aspect since most professionals insist on having their ownership and compensation arrangements definite when they begin their corporate existence. There might be difficulty in working out satisfactory financial arrangements some months or even some weeks later for the purpose of permitting another professional to merge his practice into that of the corporation.

It is possible that two professionals may wish to combine their practices in a professional corporation which contemplates that a third professional will integrate his practice consisting of accounts receivable and equipment into the corporation but at the time of the initial formation of the corporation, the third professional is under no commitment to become a part of the corporate organization. As has been pointed out, on these facts, at the time the third professional makes an exchange of property with the corporation for stock, the realized gain, if any, will be recognized since in all likelihood, the third professional will not receive the requisite control to make the transaction tax free. To enable the new shareholder to receive tax-free treatment, the existing shareholders might transfer a nominal amount of property in exchange for additional shares in the same transaction that the new shareholder transfers property for shares; the number of shares involved being worked out so that after the transaction is completed each will then own the pre-agreed number of outstanding shares. Such a program will in all probability be a futile attempt to qualify under Section 351 since the Regulations provide that where an existing shareholder transfers property of relatively small value in comparison to the stock or securities already owned, he will not be treated as a transferor for the purposes of Section 351 if the primary purpose of the transfer is to qualify another under the provisions of that section.¹⁷

The statute requires that the transferors be in control of the corporation immediately after the exchange. Control is defined as 80% of the total combined voting power of all classes of voting stock and 80% of the total number of all other classes of stock.¹⁸ Generally, because of the small number of persons involved in the formation of a professional corporation the element of control is not a problem. Likewise, the requirement that the transferors (the professionals) be in control should present no problem such as might arise in the application of Section 351 to the formation of one or more general

¹⁷ Treas. Reg. § 1.351-1(a)(1)(ii), *as amended*, T.D. 6942, 1968-1 CUM. BULL. 136.

¹⁸ INT. REV. CODE OF 1954 §§ 351, 368(c).

business corporations, with but one exception which the Service appears to have removed any risk that might have been inherent in the situation.

The potential problem referred to above is that of incorporating a partnership. If the partnership were to transfer property to the corporation in exchange for stock and thereafter be liquidated with distribution of the stock to the partners, it was felt the Internal Revenue might take the position that since the partnership was the transferring entity and after the exchange, the partners and not the partnership was in control of the corporation, then the requirements of Section 351 were not satisfied. If the partnership were liquidated, the assets distributed to the partners and then transferred to the corporation, the transferor rule would be satisfied but the partners might realize and have to recognize a gain on the liquidation of the partnership interest.¹⁹ The safest approach seemed to be to have the partners transfer their partnership interest to the corporation in exchange for stock and permit the corporation to become the owner of the partnership assets in this manner. This approach resulted in the transferors of the partnership interests being in control but since the partnership then immediately terminated there existed the technical issue of having the corporation receive partnership assets as a result of a transaction in which stock was issued for partnership interests. Thus, it could be argued that the stock was not issued for the identical property acquired by the corporation. While the problems did exist and were recognized²⁰ they have generally been disregarded by most practitioners. However, the Internal Revenue felt the topic significant enough to warrant a public ruling which treated any one of the three foregoing methods of incorporating a partnership as a transfer by the partnership of its assets and a subsequent distribution of the corporate stock to the partners, all of which the Internal Revenue concluded qualified under Section 351.²¹

On occasion a solo practitioner will have a son who wishes to join the profession with him and at the same time they will form a corporation. Quite frequently the practice will consist of substantial equipment, accounts receivable and possibly good will. The father may desire to have his son be a 50% owner of the corporation, yet the son will contribute very little towards the capitalization of the business. Where the corporation is formed under these circumstances the Internal Revenue might consider the stock received in disproportion to the interests transferred and treat the transaction in accordance with its true nature. The true nature may result in a gift from the father to the son to the extent of the disproportion. It is possible that the disproportion might be treated as compensation for future services and although this seems

¹⁹ *Id.* at § 731(a).

²⁰ N.Y.U. 18th Inst. on Fed. Tax 652.

²¹ Rev. Rul. 70-239, 1970-1 CUM. BULL. 74.

unlikely, there appears to be nothing to prevent the Internal Revenue from considering the value of the disproportionate shares as compensation for future services.²² In cases where the son becomes a shareholder of an existing corporation under similar circumstances, the gift theory remains, along with the issue of compensation for past or possibly even future services. In any event, treatment as compensation of disproportionate interests could prove troublesome to a professional corporation. Since such organizations normally pay out all of their dollar income in salaries, the corporate deduction for the compensation paid in stock will in all probability cause a net operating loss from operations and preclude a profit-sharing plan contribution. In cases where the services were rendered prior to incorporation, it is questionable if any deduction would be allowed to the corporation.

In the formation of every professional corporation the question of what property to transfer to it and under what circumstances it should be transferred requires careful analysis. For purposes of this discussion, property will be divided into two classifications; accounts receivable and equipment. It should be remembered that in many instances the problems are only applicable to the incorporation of a group practice from two or more independent practices as opposed to incorporation of a solo professional or incorporation of an existing professional partnership.

From an income tax view, the question of transferring unrealized accounts receivable is the same in all three situations. The basic question is—May unrealized accounts receivable be transferred tax-free to a corporation in the Section 351 transaction? To fully understand the problem, one must recognize that it is a well-established principle of law that income is taxed to he who earns it²³ and that the reporting of earned but uncollected income may not generally be shifted from one taxpayer to another. Since most professionals report income on the cash basis, at the time of incorporation there will be outstanding accounts receivable which if the business arrangements among the parties permit, would be advisable to transfer to the corporation for collection as corporate income so that they may be used to pay salaries and in turn become the basis for retirement plan contributions. For some time the Internal Revenue took the position that the transfer of accounts receivable to a corporation was outside the protection of Section 351 and unsuccessfully sought to consider as income to the transferor the accounts receivable at the time they were exchanged for stock or, if not at that point, at such time as they were collected by the corporation.²⁴ In another situation, among

²² Treas. Reg. § 1.351-1(b)(1) (1955), *as amended*, T.D. 6942, 1968-1 CUM. BULL. 136.

²³ *Lucas v. Earl*, 281 U.S. 111 (1930).

²⁴ *Thomas W. Briggs*, 15 CCH Tax Ct. Mem. 440 (1956).

the assets transferred to the corporation was a note for a real estate commission. Again, the Internal Revenue unsuccessfully sought to treat the note as outside the scope of Section 351.²⁵

It appears the Internal Revenue has recognized that a cash basis professional may transfer accounts receivable to a corporation tax free under Section 351. This conclusion is reached in view of the *Briggs*²⁶ and *Kniffen*²⁷ cases; the acquiescence of the Service in the latter case and a ruling subsequently issued. Particularly, the Service has ruled that for purposes of computing any gain upon the transfer of property to a corporation where a liability is assumed (the topic of assumption of liabilities to be discussed herein) trade accounts receivable transferred under Section 351 have a zero basis.²⁸ Additionally, the Internal Revenue has issued guidelines for securing advance rulings as to tax-free incorporations which include transfers of accounts receivable.²⁹ In early 1970, the then Chief Counsel of the Internal Revenue indicated, that the transfer of unrealized accounts receivable to a professional corporation where there is a bona fide transfer of a going business to the new corporation and no distortion of income results would be permitted.³⁰ Thus, the question of the ability to transfer accounts receivable tax free to a corporation appears to be well settled, but in many situations, the more difficult question is, whether or not they should be transferred, assuming there are no adverse tax implications.

The question of whether or not to transfer accounts receivable usually arises in situations where two or more practices are sought to be combined in a corporate form; the individuals desire equal stock ownership; they are able to agree on salaries for services performed while employees of the corporation; yet there is a great disparity in the accounts receivable of each which has most likely been caused by the fact that some members of the group have been in practice longer than others. Since the transfer of receivables to a corporation, owned equally by all the professionals, will shift ownership away from the professional with the highest amount of receivables, it is very likely in such cases that the highest contributor, who may also be the highest earning and paid employee of the corporation, will have his accounts receivable used to fund salaries of the lower-paid employees. Unless the salaries to be paid to the professional employees and the accounts receivable to

²⁵ Arthur L. Kniffen, 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5.

²⁶ Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956).

²⁷ Arthur L. Kniffen, 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5.

²⁸ Rev. Rul. 69-442, 1969-2 CUM. BULL. 53.

²⁹ Rev. Rul. 70-17, 1970-2 CUM. BULL. 490.

³⁰ Worthy, *IRS Chief Counsel outlines what lies ahead for professional corporations*, 32 J. Tax 88, 90 (1970).

be transferred are so closely aligned so as not to cause such problems, a different program has to be worked out.

One approach is to have each professional buy such amount of the other's accounts receivable so that each will be a transferor of the same proportion of the receivables as each of their salaries bears to the total salaries of all of them. This requires that some of the professionals come up with cash to purchase receivables and others pay tax upon the sale of receivables; neither of which will be particularly satisfactory to the parties. The reason salaries and receivables must be aligned is that in most cases, salaries are based on past performance and when a corporation begins business it will be collecting the accounts receivable which are the result of past performance. As time goes by, some professionals' salaries may tend to increase while the others may remain the same or even decrease because of increasing or decreasing productivity. Thus, there should be a relationship between salaries and receivables generated by each professional.

Another approach is to issue securities of the professional corporation (the topic of securities to be discussed in detail herein) as opposed to stock for the disparity and still keep the transaction within the confines of Section 351. This means that at some point in time the professional who received securities will be paid their face value by the corporation from its profits and in the meantime the corporation will have to pay interest on the securities since they in essence represent a loan to the corporation. The advantage of transferring the receivables to the corporation is still retained yet the corporation has in effect bought them from the particular individual involved.

The last alternative and probably the simplest and most commonly used is to keep the accounts receivable out of the corporate program in those situations where they cannot be worked in without great difficulties. Under this program, each professional collects his own receivables as they exist on the last day that he is a self-employed individual or he may assign them to the corporation for collection purposes only. The corporation will collect the receivables and remit the funds to the professional, thus acting as a mere collection agency and for "window dressing purposes" should charge some fee. Corporate collection as an agent as opposed to continued billing by individual practitioners after they have entered practice in the corporate form is preferred since it will eliminate double billings to the patients or clients as the case may be and cause less confusion in their minds. However, the segregation of payments received by the corporation under such an arrangement will be a difficult, although not overwhelming, bookkeeping task.

While not transferring the accounts receivable leaves the corporation without immediate cash income, this author's experience has been that

the group practice will normally overcome the time lag in cash flow through increased business and any initial cash shortage caused by the payment of office expenses and salaries will be made up within a matter of months. During the interim, the cash flow problems can be solved by short-term borrowings. If there is fear that by not transferring accounts receivable, nine months income may only be collected during the first twelve months of business, since many professionals have approximately three months of gross billing invested in accounts receivable, then, salaries should be adjusted accordingly.

In many instances the question of how to handle furniture and fixtures is difficult. Again, the problem usually arises where two or more independent practices are being put together since it is very likely that the group will either have more equipment than is needed or the values of the equipment each professional has to contribute to the corporation may vary to a great extent. Possibly some of the professionals will have to sell their equipment to outsiders with the attendant income tax consequences resulting from the sale. If the professionals are to be equal shareholders, a sale of certain equipment among them to equalize their interests might be done prior to incorporation; however, such sale transactions will result in immediate recognition of any gain or loss and therefore the fair market values and book values have to be carefully reviewed to determine the exact tax exposure. Not only is the payment of tax a disadvantage to this technique, but generally professionals will not want to come up with the cash to pay one of the fellow members of his group for an undivided interest in the equipment. Where there are significant differences in the values of the equipment being contributed by each professional or the group does not desire to utilize the purchase and sale technique so that they will be in a position of transferring equal interests in the equipment to be utilized by the corporation, there are two alternatives to consider. First, each professional can contribute an equal amount of equipment for stock and receive corporate securities for the balance. For example, if in the case of the formation of a two-man professional corporation, shareholder A is contributing equipment worth \$15,000 and shareholder B is contributing equipment worth \$20,000 and they are to be equal shareholders, stock could be issued to each of them for the first \$15,000 of equipment and as to shareholder B, who is contributing \$5,000 of additional equipment, he could receive a corporate security in that amount. As in the case of accounts receivable the securities will eventually have to be paid off but such a technique permits the corporation to pay off the difference in future years and avoids the need for a sale of the equipment between the prospective shareholders prior to incorporation with the disadvantage to one of having to pay cash currently and the disadvantage to the other of possibly having to pay tax currently. It must be remembered that the use of securities is a way of permitting equal stock ownership to exist, yet allow some professionals to contribute and

be paid for property which has a greater value than that which is contributed by others and is necessary for the operation of the business. However, unless there is no realized gain to begin with, that is, the value of the property contributed by each of the professionals no matter whether it be in exchange for stock or securities is not greater than its book value, any realized gain not recognized because of Section 351 will become recognized as the securities are paid off.³¹ Thus, in addition to the other aspects of utilization of securities as an equalization device, the tax which would have been reported if a sale had been made at the outset is deferred for a number of years. The disadvantages to the use of securities in this manner are that while the corporation is in effect paying for a portion of the equipment, it will not be entitled to a depreciation deduction for such, and to the extent of the securities holding shareholder's interest in the corporation, he is making repayments to himself. However, as in any business arrangement, it is not always possible to satisfy everyone and the overall long-range objectives of the parties should be the primary concern.

The second approach is to have the ownership of the equipment retained by the professionals and leased to the corporation. The advantages of the equipment being retained by its original owner and leased to the corporation are that if the original owner utilized an accelerated method of depreciation, the ability to continue the use of such will not be lost as will be the case if the equipment is transferred to the corporation.³² An additional advantage is that leasing the equipment from one of the participating professionals will alleviate the problems associated with the situation where one professional is contributing substantially more equipment than the other. Under the lease arrangement, each can be paid a uniform return based on the value of the equipment being utilized by the corporation. It is quite possible that some members of the proposed professional corporation will object to the leasing of equipment from certain of the other members since no equity is acquired with lease payments and depending on the feelings of the individuals involved, there may be objections to the continued payment of rent and never actually owning the equipment. One additional disadvantage which in the opinion of this author is worthy of consideration is that professional corporations have been upheld on the basis that they conduct business as a real corporation. While it is certainly true that in many general business corporations, equipment and real estate are leased to corporations by shareholders, it would seem that in view of the history of professional corporations one would want to do everything possible to give the impression that the corporation is something more than a mere shell. To the extent the corpo-

³¹ INT. REV. CODE OF 1954 §§ 61, 1001.

³² Treas. Reg. § 1.167(c)-1(a)(1) (1956).

ration owns equipment or leases it from persons other than shareholders, some of the corporate "window dressing" has been accomplished.

Often times the question of whether or not the corporation should own real estate has arisen. Generally it is not advantageous to have real estate titled in the name of a corporation. If the professional corporation occupies part of the building and leases the remainder any cash flow generated from the total leasing activity will be locked in the corporation with no ability to withdraw the money even assuming that the real estate activities break even from a taxable profit and loss position. If the real estate activities lose money even though cash flow is present, the ability to make profit-sharing plan contributions will be endangered. Should the real estate be profitable, the profits will be locked in the corporation and not subject to withdrawal as salary to the professionals since such a technique would be a clear indication of unreasonable compensation.

Whether or not liabilities of a cash basis professional should be transferred to a professional corporation seemed to be a fairly well settled question until the announcement by the Internal Revenue of Rev. Proc. 70-17.³³ In many cases at the time of incorporation there will be outstanding indebtedness of the business which should be paid by the business whether it is in the incorporated or unincorporated form. The basic theme of Section 351 is to permit nonrecognition of gain upon the transfer of property for stock or securities. To the extent other property is received from the corporation, i.e., cash or short-term notes, then any realized gain is recognized to the extent of the money or fair market value of the property received.³⁴ Liabilities assumed by a corporation or a corporation taking property subject to liabilities results in the assumption of the liabilities being considered as the payment of money and if it were not for the relief granted by the Internal Revenue Code³⁵ in all Section 351 transactions, liabilities assumed by the corporation would be treated as the payment of money in exchange for the property.

There are certain statutory limitations on the ability of a professional corporation to assume liabilities of its predecessor practice in order to remain within the protection of Section 357. If the amount of liabilities assumed plus the amount of liabilities to which property is subject is in excess of the basis of the property transferred, the excess is treated as money received and any realized gain is immediately recognized.³⁶ Thus, if equipment with a basis of \$10,000 is transferred for stock and the assumption by the corporation of a liability of \$12,000, it will be considered as though \$2,000 of cash was received upon the transfer

³³ Rev. Rul. 70-17, 1970-2 CUM. BULL. 490.

³⁴ INT. REV. CODE OF 1954 § 351(b).

³⁵ *Id.* at § 357(a).

³⁶ *Id.* at § 357(c).

which will be taxed as either ordinary income or capital gain rates depending on the mixture of total assets transferred.³⁷ Additionally, if the assumption of liabilities by the corporation was for the purpose of avoiding federal income tax on the exchange or did not have a bona fide business purpose, then the assumption of the total liabilities by the corporation is treated as money received³⁸ and the burden of proof that such was not the case must be sustained by the taxpayer.³⁹ While the Section 357(b) situation may on occasion arise in the formation of a professional corporation, the problem of liabilities in excess of basis (Section 357(c)) is more likely to come about at the time of formation of the corporation. Without careful examination of the records of the unincorporated business, unexpected and adverse tax consequences might be forthcoming particularly in view of the fact that cash basis accounts receivables transferred to a professional corporation have a zero basis.⁴⁰

While the ability to transfer liabilities to the corporation within the above limitations will result in no adverse income tax consequences insofar as the transfer itself is concerned, there has been some question within the profession as to whether or not certain liabilities should be transferred. For the purpose of this analysis, liabilities will be segregated into those incurred for capital outlays and those incurred for currently deductible operating expenses.

In situations where money has been borrowed to finance the purchase of equipment and the equipment is transferred to the corporation, no problem exists with respect to transferring the liability. To a certain extent assumption of the liability by the corporation might be advantageous because to the extent the liability must be repaid at a faster rate than depreciation deductions provide cash flow for such payments, the excess will be coming from income taxed at the corporate rates which in all probability will be lower than individual rates. If the liabilities in question represent currently deductible expenses when paid, the assumption of such by the corporation might result in neither the individual nor the corporation receiving a deduction at the time of payment. The theory behind this conclusion is that the individual is not entitled to take the deduction because he did not pay the expense and the corporation is not entitled to the deduction upon payment since it did not incur the expense. Thus, as to the corporation, the payment is treated as a capital item. In view of the foregoing it has been felt that each professional or for that matter the professional partnership should pay all liabilities representing currently deductible expenses prior to incorporation and that none of

³⁷ *Id.* at § 358.

³⁸ *Id.* at § 357(b)(1).

³⁹ *Id.* at § 357(b)(2).

⁴⁰ Rev. Rul. 69-442, 1969-2 CUM. BULL. 53.

those type of liabilities should be transferred. The Internal Revenue seems to have brought confusion to this area with the announcement of Rev. Proc. 70-17 and the unofficial interpretation of that procedure.⁴¹ Under the procedure it appears that the Internal Revenue will permit tax-free transfer of accounts receivable so long as accounts payable are transferred with it. If they are requiring accounts payable to be transferred one could reasonably conclude that they will permit the corporation to take a deduction for the expense payables transferred to it at the time they are paid. Why, for ruling purposes, the Internal Revenue will insist that payables be transferred at the time receivables are, seems to be a question without any real answer. Possibly, in the eyes of the Internal Revenue, the requirement that payables be transferred along with receivables will result in income being more clearly reflected on the corporate return. If this is in fact the reason, it appears that at least in the case of professional corporations, it is not a significant basis for establishing the requirement since most cash basis professionals pay all expenses prior to the end of the year. Unfortunately, the security of transferring accounts receivable and accounts payable without adverse income tax consequences is only obtained by securing a ruling under Rev. Proc. 70-17. However, the Internal Revenue has on occasion declined to issue rulings to professional corporations pending the issuance of new regulations as to the status of professional service corporations as corporation purposes under Section 7701. In Technical Information Release No. 1019 in addition to conceding the professional corporation issue, the Internal Revenue indicated that existing Regulations would be modified to reflect the change in position of the Service. As of this date, no such change in the Regulations has been proposed. In the absence of the ability to obtain a ruling and in many cases, the practicality of doing such, it is suggested that accounts receivable may be transferred without the concurrent transfer of accounts payable to a professional corporation under Section 351 without adverse income tax consequences and that payables incurred prior to incorporation representing deductible expenses should not be transferred to the corporation.

Thus far in this article the term "Securities" has been used in connection with a Section 351 transfer and as an equalizing device in the case of unequal transfers of property to a corporation owned equally by its shareholders. The use of securities is also available where the foregoing problems are not present but rather there is a desire to withdraw some of the value of the contributed property at a future date. To understand the technique of using securities one must first remember that a transaction will be tax free under Section 351 if stock or *securities* of the transferee corporation are received in exchange for property. Securities of a

⁴¹ Worthy, *supra* note 30.

corporation means an obligation of the corporation—a debt which has to be repaid. All debts of a corporation are not securities and there is no exact answer as to how long the term of an indebtedness must be in order to qualify as a security. The cases have been numerous⁴² regarding the topic with the only apparent safe conclusion to be drawn that the obligation should mature in excess of five years.

If securities are used interest will have to be paid on the principal amount until their maturity. Payment of the principal itself will not represent a deductible expenditure and will therefore have to be repaid from corporate profits. Where a large amount of securities are issued it might be wise to let the corporation accumulate its profits (and money) over the life of the securities so that the funds will be available to pay them at maturity. Accumulation of the funds can in this manner hopefully be done at the lowest tax cost since the first \$25,000 of each year's corporate profits is taxed at the rate of 22%.

By utilizing securities as opposed to stock one is able to recover a portion or possibly all of his investment in the corporation without paying individual income tax and thus not perpetuate his "locked-in" position. Distributions with respect to stock are dividends, taxable at ordinary income rates.⁴³ Payments against securities represent repayment of loans, the receipt of which is not taxable to the extent that the repayments do not exceed the basis of the securities themselves.⁴⁴ Even though the use of securities appears to have a decided advantage, their use must be tempered with sound capitalization or what was thought to be a security will be considered stock. This result stems from what is known as the "thin corporation" rule which requires that there be a reasonable relationship between debt and equity of the corporation; otherwise what shareholders feel is corporate debt to them will be considered as additional stock. Until the Tax Reform Act of 1969 there were no exact guidelines for determining whether a purported debt instrument was such or in fact represented stock. With the Reform Act came the statutory guidelines for determining whether purported debt in reality represented stock as well as the grant of authority to the Internal Revenue to promulgate Regulations in this area.⁴⁵ If the purported debt is ultimately held to be stock, interest deductions claimed will be disallowed and the principal payments themselves will be treated as dividend income to the extent

⁴² *Camp Wolters Enterprises, Inc. v. Commissioner*, 230 F.2d 555 (5th Cir. 1956); *L & E Stien, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939).

⁴³ INT. REV. CODE OF 1954 § 301(a).

⁴⁴ *Id.* at §§ 61, 1001.

⁴⁵ *Id.* at § 385.

of earnings and profits, thereafter recovery of basis and any excess treated as money received in exchange for stock.⁴⁶

If property is transferred to the corporation in exchange for stock and short-term notes or for that matter any consideration other than stock or securities, any realized gain will be recognized to the extent of the value of such other consideration.⁴⁷ The same result would be reached if the securities received as a part of the transaction were ultimately determined to in reality be short-term indebtedness. The difference between having a purported security treated as stock or treated as other consideration within the meaning of Section 351(b) is that in the former case the tax consequences occur upon the repayment of interest and principal whereas in the latter case any realized gain is recognized immediately upon the transfer at the time of formation of the corporation.

In some cases, taxpayers will seek to avoid the application of Section 351 by a transfer of certain assets such as cash and accounts receivable for stock and a simultaneous or later transfer of equipment to the corporation which is thought to be considered as a sale outside the scope of the Section 351 transaction. The objectives of this type of transaction are to recover a portion of the investment the shareholder has made in the corporation if the shareholder is willing to pay an immediate tax upon the sale of equipment to obtain a stepped up basis in the equipment to the corporation for higher depreciation deductions. This approach seems almost inappropriate in the professional corporation case since higher depreciation deductions would reduce that money available for salaries and retirement plan contributions. In any event, any form of the transaction which results in the sale of the equipment to the corporation for more than its basis to the professional will no doubt result in realization by the professional of ordinary income on the gain.⁴⁸

The most common use of the part sale transaction with respect to professional corporations occurs in situations where all assets except equipment are transferred in exchange for stock. Thereafter, the equipment is sold to the corporation for its book value so that the transferring professional will realize no gain or loss on the transaction. If all goes well under this method the transferor of the equipment will be able to recoup a part of his investment in the corporation at such time as he receives payment for the equipment which might be in a lump sum or on an installment basis. The use of such a technique is dangerous in general business corporations and even more so in professional corporations. Where equipment is sold to a corporation simultaneously with the transfer of other property for stock or sold immediately

⁴⁶ *Id.* at § 301(c)(3)(A).

⁴⁷ *Id.* at § 351(b).

⁴⁸ *Id.* at §§ 1239, 1245.

thereafter, one can surely expect the Internal Revenue to treat both transactions as one within the meaning of Section 351 with the result that the transferring professional will be considered to have received stock and other property (either money or notes for the purchase price of the equipment) as a part of the exchange.

If the exchange and sale transactions are considered as one transaction within the scope of Section 351, the professional will be considered to have received stock and other property in exchange for the property he transfers and any gain realized will be recognized to the extent of the value of the other property. For example, if accounts receivable with a basis of zero and fair market value of \$10,000 along with \$500 of cash are transferred to a corporation in exchange for stock, the transaction to that point is tax free. If however, immediately after the foregoing transaction, the professional sells equipment to the corporation at an assumed book value of \$10,000, in exchange for a note payable over two years, the Internal Revenue will in all probability consider both transactions as one transaction under Section 351 with the result that the professional will have received stock and other property (the two-year note) in exchange for that which he transferred. The stock will be worth the sum of the cash, accounts receivable and the value of the equipment (assuming the fair market value to be equal to book value) or a total of \$20,500. The basis of the professional in the assets transferred will be \$10,500; therefore, the realized gain of \$10,000 will be recognized to the extent of the value of the promissory note and be taxed as ordinary income since the gain is attributable to accounts receivable.

Thus far, this discussion has assumed that the transferring professionals as well as the corporation utilize the cash receipts disbursements method of accounting. It is probably safe to assume that such will nearly always be the case, but in view of the differences between the cash and accrual methods, some comment is deserving in this area.⁴⁹

The primary concern with accrual basis transferors is that of accounts receivable. Since the accrual basis results in recognition of income at the time earned, there would appear to be no reason to transfer accrual basis accounts receivable to the professional corporation in a Section 351 exchange. In fact, there are a number of excellent reasons for not doing so. First, since the income has been reported, the individual collection of the receivables after incorporation will result in the receipt of tax-free money. If the accrual receivables are transferred to the corporation the collection will not represent income to the corporation and they will therefore not serve the purpose of providing income from which to pay salaries. Additionally, if accrual receivables are

⁴⁹ *Id.* at § 446(c).

transferred in exchange for stock, the funds become locked in the corporation and their withdrawal will be subject to dividend treatment if earnings and profits of the corporation are permitted to accumulate. It is submitted that there is no sound reason for transferring accrual basis accounts receivable to a corporation in exchange for stock and that if the corporation needs funds generated by the collection of the receivables, the professionals should individually collect the accounts and loan the money to the corporation. If this is done, the matter of "thin capitalization" must be considered so that the loans will not be treated as equity investments. An additional precautionary step which can be taken in the event the corporation is in need of funds is to have the corporation borrow the money from a bank with the individual professional(s) guaranteeing the corporate loan. Utilization of this technique will not result in any direct transfer of money from the corporation to the professionals which can be readily attacked as equivalent to a dividend. Repayment directly to a bank eliminates any transaction between the corporation and the professionals and thus presents another hurdle for the Internal Revenue to overcome in any case involving the thin corporation issue.

With respect to accounts payable representing expense items, so long as their amount is not in excess of the basis of the assets transferred, there is no harm in transferring them to the corporation. The deduction is allowable to the individual in the year that it is incurred and therefore the possibility that neither the professional nor the corporation receiving the deduction is not present as it is in the situation of a cash basis taxpayer. As to payables representing outlays for capital expenditures the situation is the same both for accrual basis and cash basis transferors.

While no doubt, most professional corporations will utilize the cash method of accounting, in the larger practices, the use of the accrual method for business management purposes and the cash method for tax purposes is a technique worthy of consideration. Properly utilized, the accrual method presents a much more accurate picture of the results of operations and the financial position of the business as opposed to that which is presented by financial statements prepared on a cash basis.

While at first impression one might conclude that if the accrual method is used for book purposes, it must also be used for tax purposes,⁵⁰ there is authority in support of maintaining books and records on the accrual basis but reporting income for tax purposes on the cash basis.⁵¹ In connection with the method of accounting to be used by the corporation one might conclude that if a cash basis transferor were to transfer accounts receivable to an accrual basis professional corporation, the collection of the receivables might escape taxation to the corporation on

⁵⁰ *Id.* at § 446(a).

⁵¹ Rev. Rul. 68-35, 1968-1 CUM. BULL. 190.

the basis that the income was not earned by it. One might conceive a program whereby a cash basis professional transfers \$25,000 of accounts receivable with a zero tax basis along with equipment with a basis of \$25,000 to a professional corporation in exchange for stock with the corporation electing to utilize the accrual method of accounting. As the receivables are collected they are excluded from income since they were not earned by the corporation. At the end of the year the corporation has no taxable income because the salaries and retirement plan contributions are geared to absorbing all profits. Theoretically the corporation still has the cash representing collection of the \$25,000 of accounts receivable. Since there are no other profits one might then attempt to withdraw the \$25,000 cash as a return of capital.⁵² If this program were successful the result would be to have collected the \$25,000 of accounts receivable tax free. While it is true that the basis of the professional's stock in his corporation would be reduced to zero such a consequence does not represent a substantial disadvantage since the time when any professional will recover the basis of his stock is conjectural, usually arising upon a sale of the stock or a liquidation of the corporation and either of which events are not usually contemplated at the time the corporation is formed. No doubt, such a scheme would be vigorously attacked by the Internal Revenue and although this author suggests it as a possibility, no expression as to the likelihood of its success is given and any practitioner utilizing it should be prepared to defend his action.

The matter of the basis of assets transferred to a corporation in a Section 351 transaction and the basis of the stock or securities received is clearly established. The basis of the assets to the corporation is the same as the basis of the assets in the hands of the transferor increased by the amount of gain recognized to the transferor on the transfer⁵³ and the total basis of the stock and securities received by the transferor is clearly established by Section 358 of the Code.

There are various sections of the Code triggering tax consequences upon the disposition of property. For example the disposition of personal property and real property bring into play the recapture provisions.⁵⁴ However, in both cases, if the transaction qualifies under Section 351 the recapture provisions will not operate to cause the recognition of any gain.⁵⁵ A similar problem is present in connection with investment credit recapture. Where property is transferred to a corporation, does the transfer represent a disposition triggering recapture of the investment credit? The answer is generally no. The mere change in the form of doing business

⁵² INT. REV. CODE OF 1954 § 301(c) (2).

⁵³ *Id.* at § 362.

⁵⁴ *Id.* at §§ 1245(a), 1250(a).

⁵⁵ *Id.* at §§ 1245(b) (3), 1250(d) (3).

does not constitute an early disposition where the conditions set forth in the Regulation are met.⁵⁶ One of the requirements being that the transferors retain a substantial interest in the transferee, the question of what is a substantial interest is also covered by the Regulations.⁵⁷ A partner is considered to have retained a substantial interest in the business if his interest in the transferee business is substantial in relation to the total interest of all other persons or is equal to or greater than his interest prior to the change in the form. Thus, if a partner owns a 25% interest in a partnership and after incorporation of the partnership he retains at least a 25% interest in the corporation, he will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

Having reviewed the tax and some of the business considerations in the transition to a professional corporation, attention is now directed to certain matters and their attendant tax consequences which arise in the operation of a professional corporation.

For a number of years the Subchapter S election was available to professional corporations.⁵⁸ Generally, election under Subchapter S permitted the corporation to operate in the corporate form yet have its income treated as that of a partnership. Election under Subchapter S solved the possibility of the unreasonable compensation issue (to be discussed herein) as well as eliminating any risk inherent in transferring of cash basis accounts receivable to the corporation. The Tax Reform Act of 1969 effectively eliminated the use of the Subchapter S provision by professional corporations. Specifically, the Reform Act added Section 1379 which became effective for taxable years of Subchapter S corporations beginning after December 31, 1970, and provides that the deductions to qualified retirement plans on behalf of shareholder-employees shall essentially be limited to that available under a Keough Plan.⁵⁹ With the enactment of this section, the practical use of Subchapter S for professional corporations faded from existence.

There has been some thought that the income of a professional corporation represents what is known as personal holding company income, and as such would be subject to a 70% tax if not distributed.⁶⁰ A personal holding company is a corporation whose income is primarily passive in nature; that is, consists of rents, interest and dividends. Were it not for the personal holding company provisions, high-bracketed individuals would allow such items to accumulate in the corporation at a lower tax and possibly liquidate the corporation in the future on the

⁵⁶ Treas. Reg. § 1.47-3(f)(1).

⁵⁷ *Id.* at § 1.47-3(f)(2).

⁵⁸ INT. REV. CODE OF 1954 § 1372.

⁵⁹ *Id.* at § 1379(d).

⁶⁰ *Id.* at § 541.

basis of a capital gain transaction. The combined corporate tax and capital gains tax could turn out to be less than the tax had the income been personally received. To avoid this there is imposed a 70% tax on the undistributed income of a personal holding company. Included in the definition of personal holding company income is income from personal service contracts.⁶¹ Personal service contracts are those under which the corporation receives money for furnishing personal services if some person other than the corporation has the right to designate by name or description the individual who is to perform the services or if the individual who is to perform the service is designated by name or description in the contract. To be a personal holding company, more than 50% of the corporation's outstanding stock during the last half of the year must be owned directly or indirectly by or for not more than five individuals.⁶² If such requirement is satisfied then income generated by a person who is directly or indirectly a 25% or more shareholder of the corporation at any time during the year is considered personal holding company income.⁶³ It has been felt that in those cases where the statutory number of shareholders is satisfied that there is an implied contract between the professional and the individual who is requesting the services which requires that the particular professional perform them as opposed to the corporation itself. The usual case of imposition of the personal holding company tax is in situations where an individual pursuant to a written contract has the right to designate who will perform the services. However, in the case of the professional corporation there are generally no such contracts and the most that can be said is that the individual is merely expecting that a certain individual will perform the services. Whether such expectation is the same as "right to designate"⁶⁴ is uncertain. The problem is most prevalent in the one-man corporation and in one case involving such a situation, the Tax Court held that the mere expectation that a certain person perform the services was insufficient.⁶⁵

In most cases, the question of imposition of the personal holding company tax is more theoretical than practical. Inasmuch as professional corporations generally distribute all of their profit through salaries and retirement plan contributions, there will be little, if any, income to be subjected to the 70% tax. In any event, where income is left to accumulate in the small professional corporation, the threat of being treated as a personal holding company and taxed accordingly does exist and the practitioner should be aware of this problem in advising his client as to whether or not to retain earnings in the corporation. Should

⁶¹ *Id.* at § 543(a) (7).

⁶² *Id.* at § 542(a) (2).

⁶³ *Id.* at § 543(a) (7).

⁶⁴ *Id.*

⁶⁵ S. O. Claggett, 44 T.C. 503 (1965).

there be situations where the corporation has entered into contracts to perform services, the specification of any individual person to perform such services should be avoided.

Assuming that the personal holding company's provisions are not a problem the idea of retaining earnings in the corporation must be viewed with the possibility of imposition of the accumulated earnings tax.⁶⁶ The accumulated earnings tax need only be considered when the accumulated earnings and profits of the corporation exceed \$100,000 and then generally only to the extent of each year's additions to the accumulated earnings which are not shown to have been retained for the reasonable needs of the business. It would be highly unusual for a professional corporation to accumulate \$100,000 of earnings and profits unless the corporation was deeply involved in the ownership of buildings and equipment. Even in those cases the likelihood of such an accumulation would seem rather remote and therefore it is sufficient to say that this issue represents a very minor threat and should merely be remembered when operating a professional corporation.

There is a section of the Internal Revenue Code which provides: if any person or persons acquire control of a corporation on or after October 8, 1940, either directly or indirectly, and the principal purpose for the acquisition was the avoidance of federal income tax by the securing of the benefit of a deduction which such person or corporation would not otherwise enjoy, then the Internal Revenue may disallow such deduction.⁶⁷ Control is defined as ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of all shares of all classes of stock of the corporation. There has been the thought within the profession that the Internal Revenue might utilize Section 269 to deny deductions for retirement plan contributions on the basis that the obtaining of such deduction was the principal purpose for the formation of the corporation. Even if it is assumed that the corporation was organized principally for the purpose of taking advantage of the Code provisions regarding retirement plan contributions, it is questionable whether such a purpose would constitute "evasion or avoidance" of taxes within the meaning of Section 269. The Internal Revenue has ruled that the creation of a corporation for the purpose of obtaining advantages authorized by another section of the Code does not constitute tax avoidance within the meaning of Section 269.⁶⁸ The deductions for retirement plan contributions are taken pursuant to Code sections which specifically grant

⁶⁶ INT. REV. CODE OF 1954 § 531.

⁶⁷ *Id.* at § 269(a)(1).

⁶⁸ I.T. 3757, 1945 CUM. BULL. 200.

them and it would appear very doubtful that the Internal Revenue could use Section 269 in nullifying the advantages of a professional corporation.

The Internal Revenue Code gives the Service the ability to allocate income and deductions among two or more trades or businesses if it is determined that such is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such business.⁶⁹ It has been felt that, particularly in the one-man professional corporation, the Internal Revenue might under the broad provisions of Section 482 take the position that the income of the corporation should be attributed to the individual who earned it. In the past, with respect to personal services, this section has been used to allocate back to an individual the income of an individual who had formed a one-man corporation.⁷⁰ However, in that case, the income generated from the personal services was used to offset losses from another business being carried on by the corporation and in this respect is totally different from that of the professional corporation. However, the Tax Court has found Section 482 to be applicable to a professional corporation case⁷¹ which on its peculiar facts made it definitely apparent that the business was not being conducted in the corporate form. The various shareholders of the corporation merely put their income together for bookkeeping purposes and never actually combined their offices or did anything different than that which they had done in the unincorporated form except for the combination of income for accounting purposes in an attempt to classify themselves as a professional corporation. This case is certainly not representative of the manner in which most professional corporations are organized and since it is the only professional corporation case to date which has been lost by the taxpayers it provides excellent criteria for how not to organize and operate a professional corporation.

Probably one of the most viable methods for the Internal Revenue Service to attack the professional corporation is in the area of reasonable compensation. Under Section 162 of the Code, a deduction is allowed for reasonable compensation and the question of what is reasonable is determined by the facts and circumstances of each case. It would seem that if the salary received from the corporation is the same as what the professional would have earned in the unincorporated form, there should be no question but that his salary is reasonable. In some cases this may be true. However, there are the cases of those professionals such as dentists and radiologists whose equipment and technicians produce a return which might represent a substantial portion of the net income of the business. In the corporate form, the professional is only entitled to be compensated for

⁶⁹ INT. REV. CODE OF 1954 § 482.

⁷⁰ *Borge v. Commissioner*, 405 F.2d 673 (1968).

⁷¹ *Roubik*, 53 T.C. 365 (1969).

his services and since the corporation is a separate taxable entity, the professional's salary may not include the income earned by the corporation from the investment in equipment or the services of technicians. On the other hand, in support of syphoning off the profits from these sources as salaries to the professionals it could be argued that the equipment and technicians would produce no income if the professionals themselves were not present. The guidelines for establishing what represents reasonable salary for professionals are few not only from the point of view of the professional corporation area but from the aspect of the amount of money involved. For example, who is to say whether a professional is worth \$60,000 a year instead of \$70,000 a year, as was paid to him? Going further, who is to say that a physician while unincorporated and earning \$125,000 a year is not worth the same amount of money as an employee of a corporation which has numerous technicians and substantial amounts of equipment that could not function without his being there to supervise? Even though there are potential unreasonable salary problems in the professional corporation area it is quite evident that professionals will continue to withdraw all corporate profits in the form of salaries and retirement plan contributions. While the burden of proof as to the reasonableness of the salary remains with the taxpayer in the event of disallowance by the government, the government may find itself in a difficult position to justify litigating the salary of a professional unless some very unusual facts and circumstances exist which clearly indicate that the salary paid is unwarranted. Before leaving the area of salaries, it should be remembered that it appears there is nothing to prevent the government from reallocating salaries among professionals pursuant to Section 482 even though the salaries in total do not represent an unreasonable amount or from reallocating the salaries to the professionals themselves. Such reallocation might take place in a situation where the professionals are related such as father and son with a clear indication that one is being overpaid and the other is being underpaid with the purpose of the program being to avoid income tax. Where these types of relationships do exist, the situation should be observed carefully so that application of Section 482 may be prevented.

In many of the situations where professionals are being incorporated, consideration will have to be given to the existing Keough plan. If the plan is terminated, distributions to owner-employees prior to their attaining age 59½, of contributions which have been previously deducted might be subject to a penalty tax. If the amount prematurely distributed in any taxable year is less than \$2,500 the tax with respect to such amount is 110% of the increase in tax which results from including such amount in the individual's gross income for the taxable year involved. For example, if an owner-employee receives a \$2,000 distribution prior to age 59½, which amount would be taxed to him in the 20% bracket, the increase in tax ordinarily would be \$400, which is 20% of \$2,000.

However, since the penalty provision is applicable the tax would be \$440, being 110% of the initial tax.

If the amount received in a premature distribution equals or exceeds \$2,500, the tax with respect to the amount is the greater of the increase in tax attributable to the inclusion of the amount so received in the gross income of the owner-employee for the taxable year in which received or 110% of the aggregate increase in taxes for the taxable year of distribution and the four immediately preceding taxable years which increase would have resulted if such distribution had been included in the owner-employee's gross income ratably over such years. Thus, before withdrawing money from an existing Keough plan prematurely, consideration should be given to the possible penalty.

There are alternatives to premature distribution of the assets. It is possible to "freeze" the plan and make no further contributions to or withdrawals from it. In this connection, if the Keough plan contains insurance policies as an asset, rather than let the policies lapse, the professional may wish to continue contributions to the plan so as to make the premium payments and not let the policy lapse but such contributions will be on a nondeductible basis.

Another alternative is to transfer the assets of the Keough plan to the corporate plan established by the professional corporation. The Internal Revenue has ruled that such a transfer is permissible so long as the corporate plan incorporates and makes applicable to former owner-employees the provisions of Section 401(d) of the Code and Regulation Section 1.401-12.⁷² Additionally, it is required that there be separate accounting for the gains and losses with respect to the assets transferred from the Keough plan and in the event of a distribution from the corporate plan, the trustee must be able to identify the assets representing transfers from the Keough plan and corporate contributions so that the source of each distribution can be determined.

CONCLUSION

As one can see, the tax considerations in the formation and operation of a professional corporation are numerous and, unfortunately, there are many areas which lack definite guidelines so as to enable the practitioner to give as definite an answer as he would like to. However, as with any new area of tax law, it will take time, decisions and rulings to develop what one may term as reasonable guidelines for reaching a conclusion. In the meantime, there is little doubt that with careful planning in the formative stages and close observation of the operation of a professional corporation, the risk of problems with the Internal Revenue may be minimized if not eliminated and the substantial benefits to be obtained by incorporating a professional practice enjoyed for many years to come.

⁷² Rev. Rul. 71-541, 1971-2 CUM. BULL. 209.